



DEFENSE FINANCE AND ACCOUNTING SERVICE

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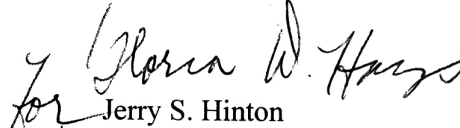
DFAS-DFM

MEMORANDUM FOR OFFICE OF THE UNDER SECRETARY OF DEFENSE
(COMPTROLLER)(ODCFO)(FD)
DIRECTOR, RETIRED AND ANNUITANT PAY OPERATIONS,
DEFENSE FINANCE AND ACCOUNTING SERVICE

SUBJECT Update to the Department of Defense Financial Management Regulation
(DoDFMR), Volume 7B, Regarding Taxability of Survivor Benefit Plan (SBP)
Cost Refunds (DFAS Item J-47)

This is an interim change **R-01-01** to the DoDFMR, Volume 7B. This change is effective immediately. This change incorporates the taxability of an SBP cost refund which is dependent on whether the SBP cost was deducted from gross retired pay or Department of Veterans Affairs compensation (DVA). If the cost is deducted from retired pay, the refund is taxable. However, if the cost is deducted from DVA compensation, the refund is not taxable.

We have evaluated your comments on the proposed change and included your comments where appropriate. Assignment of an interim change number is your authority to initiate procedural modifications to facilitate this change. Use the attached to initiate the formal change to the DoDFMR, Volume 7B.


for Jerry S. Hinton
Acting Director for Finance

Attachment:
As stated

cc DASD (MMP)(COMP)
ODGC (F)
DFAS-GAM/DE
DFAS-PMJE/DE
Services Liaisons
USCG/NOAA/PHS Liaisons

1. Revise section 5301 in its entirety to read:

"5301 FEDERAL INCOME TAX

530101. Taxability of SBP Annuity Payments. SBP annuity payments are taxable for federal income tax purposes. See table 53-1 for exceptions to their taxability. See paragraph 530203 for when SBP annuity payments are treated as "designated distributions" for tax withholding purposes.

530102. Taxability of SBP Cost Refunds. A refund of SBP costs (i.e., SBP premiums, per subparagraph 530203.A) resulting from an administrative error, correction of records, or awarding of DIC may or may not be taxable income to the member or the annuitant. The taxability of a SBP cost refund depends on the source from which it is made (also see Table 53-2):

A. It constitutes taxable gross income to the retired member or the annuitant when it is made from the premium deductions made from the retired member's taxable retired pay to pay for the cost of SBP coverage (defined in paragraph 420207).

B. It does not constitute taxable gross income to the retired member or the annuitant when it is made from the retired member's direct remittance payments (by check) to pay for the cost of SBP coverage.

C. It does not constitute taxable gross income to the retired member or the annuitant when it is made from the retired member's VA disability compensation or by deduction from nontaxable military disability retired pay.

2. Add Table 53-2 as follows:

| TAXABILITY OF SBP COSTS REFUND | | | |
|--------------------------------|---|---------------------------|--------------|
| R U L E | A | B | C |
| | If the source of refunded cost is for | then it is taxable to the | |
| | | member | annuitant |
| 1 | premium deductions from taxable retired pay | yes (note 1) | yes (note 2) |
| 2 | premiums paid from VA Disability compensation or premiums deducted from non-taxable military disability retired pay | no (note 3) | no (note 4) |
| 3 | premiums paid directly by member | no (note 5) | no (note 6) |

NOTES:

1. Internal Revenue Code section 122 caused amounts deducted from military retired pay to fund an SBP annuity to be excluded from income. Had the deducted amount been paid directly to the member instead, it would have been fully taxable. Consequently, refunded costs that were taken from military retired pay constitute gross income to the member.
2. Under Internal Revenue Code section 691, the refund is income in respect of a decedent. The tax status of the refund is the same to the annuitant as it would have been had it been refunded to the member. Since the refund of costs deducted from military retired pay would have been gross income to the member, it is also gross income to the annuitant.
3. VA disability compensation is exempt from taxation. 38 U.S.C. § 5301. Under certain circumstances, military disability retired pay is also nontaxable. 26 U.S.C. § 104. If the deducted amount had been paid directly to the member instead, it would have been exempt from taxation. Consequently, refunded costs that were taken from VA disability compensation or nontaxable military disability retired pay are also exempt from taxation.
4. Under Internal Revenue Code section 691, the refund is income in respect of a decedent. The tax status of the refund is the same to the annuitant as it would have been had it been refunded to the member. Since the refund of costs deducted from VA disability compensation or from nontaxable military disability retired pay would have been excluded from the gross income of the member, it is excluded from the gross income of the annuitant.
5. Amounts paid directly by the member to fund the SBP annuity were subject to tax before they were paid by the member. Direct payments by the member do not result in any tax benefit to the member. Consequently, refunds of premiums that were directly paid by the member constitute a nontaxable return of capital and do not constitute gross income.
6. Since the refund would have been a return of capital in the hands of the decedent (and would not have been includible in the decedent's gross income), it is also a return of capital to the decedent's beneficiary (and is not includible in the gross income of the beneficiary of the decedent).

Table 53-2 - Taxability of SBP Cost Refunds

3. Add the following to the Bibliography:

Paragraph

Citation

"530102

DoD/GC(Fiscal) opinion,
Mar 7, 2000

Table 53-2

DoD/GC(Fiscal) opinion,
Mar 7, 2000"

4. Miscellaneous Item. Cross-Reference List (page xxxiv), under Chapter 42, replace the old numbering based on Interim Change R8-96 as follows:

"(none) 420230" to "90102ad 420230 (IC R8-96)